SUPREME COURT, U. S.
AUG 9 1967
JOHN F. DAVIS, CLERK

IN THE

Supreme Court of the United States

October Term, 1967

No. 476

W. THOMAS DAVIS, ELIZABETH LLOYD DAVIS, CAROLYN L. DAVIS and PHILIP CAROL DAVIS and CAROLYN LYLE DAVIS, as Executors of the Estate of M. PHILIP DAVIS, Deceased,

Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

Petition for a Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit.

ARTHUR A. ARMSTRONG,
ARMSTRONG, BROWN & SHERMAN,
458 South Spring Street,
Los Angeles, Calif. 90013,
Counsel for Petitioners.

Parker & Son, Inc., Law Printers, Los Angeles. Phone MA. 6-9171.

SUBJECT INDEX

	Page
Opinions Below	2
Jurisdiction	2
Question Presented	2
Statutes Involved	2
Statement	3
Reasons for Granting the Writ	6
Conclusion	12

INDEX TO APPENDICES

Appendix A. Opinion of the United States Court of Appeals for the Ninth Circuit A-1

Judgment A-2

Appendix B. Memorandum Findings of Fact and Opinion B-1

Appendix C. Letter From Dale E. Cunningham to Arthur A. Armstrong, dated June 20, 1967 .... C-1

Letter From Wm. F. Cowan to the Honorable Chief Justice and Associate Justices, dated June 2, 1967 ..... C-2

TABLE OF AUTHORITIES CITED

Cases	Page
Apex Brewing Co., Inc. v. Commissioner, 40 B.T.A. 1110, acq. 1940-1 C.B. 1	8
Commissioner v. South Lake Farms, Inc., 324 F. 2d 837	7
Eisner v. Macomber, 252 U.S. 189	6
F. & D. Rentals, Inc. v. Commissioner, 365 F. 2d 34, cert. den. 385 U.S. 1004, aff'g. 44 T.C. 335	9, 11, 12
Farmers Cotton Oil Company v. Commissioner, 27 B.T.A. 105	8
Fox & Hounds, Inc. v. Commissioner, T.C. Memo 1962-229, 21 T.C.M. 1216	8
L. M. Graves v. Commissioner, T.C. Memo of 5-14-52, 11 T.C.M. 467	10, 11
Harlan E. McGregor v. Commissioner, T.C. Memo Dec. 1955-223, 14 T.C.M. 897	8, 9
Henry S. Alper v. Commissioner, T.C. Memo 1962-38, 21 T.C.M. 185	8
James K. Herbert v. Commissioner, 62-1 U.S.T.C. 9177	8
James F. Suter, Estate of, v. Commissioner, 29 T.C. 244, acq. 1958-2 C.B. 8	8
La Belle Iron Works v. United States, 256 U.S. 377	7
Lynch v. Turrish, 247 U.S. 221	6
Nathan Blum v. Commissioner, 5 T.C. 702	9
Palmer v. Commissioner, 302 U.S. 63	6

Page

Philadelphia Steel & Iron Corporation v. Commissioner, T.C. Memo 1964-93, 23 T.C.M. 558, aff'd 334 F. 2d 964 8

Richard J. Zemmer v. Commissioner, T.C. Memo 1963-131, 22 T.C.M. 638 8

T. H. Symington & Son, Inc. v. Commissioner, 35 B.T.A. 711, acq. 1937-2 C.B. 27 ..... 9, 10

The American Fork and Hoe Company v. Commissioner, T.C. Memo of 9-22-43, 2 T.C.M. 842 8

The Bessemer Limestone and Cement Company v. Commissioner, T.C. Memo Dec. 1956-250, 15 T.C.M. 1277 11

Watson v. Commissioner, 345 U.S. 544 9

Rulings

O.D. 714, 3 C.B. 49 ..... 8, 9, 11

I.T. 3815, 1946-2 C.B. 30 8

Statutes

Internal Revenue Code, Sec. 111 2

Internal Revenue Code, Sec. 113 3

Internal Revenue Code, Sec. 268 7

Internal Revenue Code, Sec. 337 7

Internal Revenue Code, Sec. 341 7

Internal Revenue Code, Sec. 1231(b)(4) 7

Internal Revenue Code, Sec. 1245 7

Internal Revenue Code, Sec. 1250 7

United States Code, Title 28, Sec. 1254 2

IN THE

Supreme Court of the United States

October Term, 1967

No. .....

W. THOMAS DAVIS, ELIZABETH LLOYD DAVIS, CAROLYN L. DAVIS and PHILIP CAROL DAVIS and CAROLYN LYLE DAVIS, as Executors of the Estate of M. PHILIP DAVIS, Deceased,

Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

Petition for a Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit.

Petitioners, W. Thomas Davis, Elizabeth Lloyd Davis, Carolyn L. Davis and Philip Carol Davis and Carolyn Lyle Davis, as Executors of the estate of M. Philip Davis, deceased, pray that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Ninth Circuit in the above-entitled case. M. Philip Davis, petitioner to the Tax Court and Court of Appeals, died March 6, 1967, after argument before the Court of Appeals but before its decision; Philip Carol Davis and Carolyn Lyle Davis were appointed Executors of his estate by order of the Superior Court, Los Angeles County, California, on March 22, 1967 and are being substituted as parties hereto by stipulation.

Opinions Below.

The per curiam opinion of the Court of Appeals is reported at 375 F. 2d 517 and reproduced in Appendix A hereto. The opinion of the Tax Court (T.C. Memo, 1965-30, 24 T.C.M. 157) is reproduced in Appendix B hereto.

Jurisdiction.

The judgments of the Court of Appeals were rendered on March 17, 1967 [R. 94, 95].[1] See Appendix A hereto. By Order dated June 12, 1967, Mr. Justice Douglas extended the time for filing a petition for writ of certiorari to and including August 14, 1967. The jurisdiction of this Court is invoked under 28 U.S.C. 1254.

Question Presented.

Whether the purchasers of an orchard realized taxable gain because they arranged for a cash sale of the crop on the trees to occur at the time of purchase and applied the cash upon the lump-sum price for the orchard and crop.

Statutes Involved.

Internal Revenue Code of 1939:

> SEC. 111. DETERMINATION OF AMOUNT OF, AND RECOGNITION OF, GAIN OR LOSS.
>
> (a) *Computation of Gain or Loss.*—The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 113(b) for determining gain, and the loss shall be the excess of the adjusted basis provided in such

[1] R. refers to Volume I of the transcript of record.

section for determining loss over the amount realized.

* * *

SEC. 113. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS.

(a) *Basis (Unadjusted) of Property*—The basis of property shall be the cost of such property; except that—

[Exceptions not pertinent]

(b) *Adjusted Basis.*—The adjusted basis for determining the gain or loss from the sale or other disposition of property, whenever acquired, shall be the basis determined under subsection (a), adjusted as hereinafter provided.

[Adjustments not pertinent]

Statement.

In early 1953 the Davis brothers, W. Thomas ("Tom") and M. Philip, concluded arm's length negotiations with the stockholders of Del Norte Citrus Co. ("Del Norte"), a corporation, by acquiring options to purchase all of the outstanding Del Norte stock. The Davises' objective was to own the lemon orchard ("orchard") which was the principal asset of Del Norte and consisted of the following ("fixed orchard assets"): 428 acres of land in Ventura County, California, of which 354 were planted with lemon trees; and the related wells, tanks, irrigation lines, roads, buildings, wind machines and other improvements. App. B 2-4.[2]

[2]Evidentiary facts found by the Tax Court are undisputed. References thereto are given herein as references to pages of Appendix B where the Tax Court's findings and opinion are reproduced.

About $500,000 cash was needed to conclude the purchase. The Davises did not have it, but hoped to raise it by utilizing the other assets of Del Norte ("quick assets") which consisted of: cash, the lemon crop set on the trees ("lemon crop"),[3] picked lemons in the packinghouse, accounts receivable, revolving fund certificates and a few miscellaneous items. App. B 3-4, 16.

Because of the advent of frozen juice, there was a most unusual demand for lemons for juice concentrates. Tom realized that he might be able to arrange for sale of the lemon crop at a high price and opened negotiations with juice processors in July 1953. In September, 1953, the Davises concluded an arm's length contract with Golden Citrus Juices, Inc. ("Golden Citrus") whereby it would purchase the lemon crop for $238,000[4] cash as soon as the Davises acquired the orchard. App. B 3-11.

In September 1953 several escrows were opened and on September 17, 1953 Golden Citrus deposited the $238,000 into one of them. On or about September 22, 1953, utilizing these escrows, the transactions were concluded as follows: The Davises exercised their options and purchased the Del Norte stock, paying cash and notes; Del Norte was dissolved and distributed all of its assets to the Davises; the Davises delivered Golden Citrus a bill of sale for the lemon crop; the $238,000, along with cash in Del Norte's bank accounts, was paid to the Del Norte stockholders upon the price for their stock. App. B 11-13.

---

[3]The lemons set on the trees at a given time range from pea size to mature lemons; lemons in the Ventura area are harvested more or less continuously. App. B 3.

[4]For simplification, figures herein are rounded to the nearest thousand.

Each of the Davises reported his 50% interest in the foregoing transactions on his 1953 tax return. An identical schedule appended to each return reflected a total price of $890,000 ($472,000 cash, $395,000 notes, $23,000 assumption of payables) paid for 100% of the Del Norte stock, and allocated it as follows: the first $466,000 to quick assets, including the lemon crop at $238,000; the balance of $424,000 among fixed orchard assets prorated according to relative assessed values. The economic reality to the Davises was that they had purchased the orchard for $424,000 (they did not exercise their options to buy the Del Norte Stock until they knew that the quick assets could be converted to cash to apply upon the total price). The Commissioner disturbed this treatment by reducing the value of the lemon crop to $35,000 and prorating $203,000 ($238,000 minus $35,000) among the fixed orchard assets. App. B 15-19, R. v. ii, 311-312, 344-345.

The Tax Court found that the lemon crop had a realized sale value of $213,000, *i.e.*, $238,000 minus $25,000 deemed paid by Golden Citrus for the Davises' obligation to mature the crop.[5] App. B 14-15. But the Tax Court then reallocated the total $890,000 price as follows: the first $228,000 to quick assets other than the lemon crop; the balance of $662,000 prorated between the lemon crop, at its realized sale value of $213,000, and the fixed orchard assets, at an assumed $823,000 value derived from opinion testimony of the government's appraisal witness (the Davises have never sold the orchard). The result was an allocated cost of $136,000 for the lemon crop and an assumed profit of

[5]Petitioners have not contested this $25,000 adjustment.

$77,000 ($213,000 minus $136,000)[6] derived by the Davises from its sale. App. B 22, 30-31.

Thus, by substituting the $823,000 appraised value of fixed orchard assets for their $424,000 cost, a profit has been constructed upon the sale of the lemon crop for its cash value.

Petitioners appealed the cost allocation issue to the Ninth Circuit Court of Appeals, which affirmed the Tax Court *per curiam.*

Reasons for Granting the Writ.

The decision below violates a fundamental rule of income tax law, long ago established by this Court, that taxable gain is realized by disposition; it is not realized by acquisition, even though at a bargain price. *Palmer v. Commissioner,* 302 U.S. 63 (1937). *Cf. Eisner v. Macomber,* 252 U.S. 189 (1920); *Lynch v. Turrish,* 247 U.S. 221 (1918).

A going business normally is made up of fixed assets, used for production, and quick assets that will currently be converted to cash. In addition to accounts receivable, the quick assets usually include product or inventory. Realization of cash from quick assets is a function of operating, not disposing of, fixed assets.

When a going business is sold for a lump-sum price to a purchaser who intends to continue its operation, and the purchaser sells product or other quick assets for their value at point of purchase, he is not producing income by his own operation but merely realizing in

[6]The Tax Court speaks of $102,000 profit, which is the $77,000 plus the $25,000 paid for crop care until maturity. App. B 31.

cash an income value created by the seller.[7] Certainly he is not realizing gain attributable to the salable value of the fixed assets, since he continues to hold and operate them, just as the seller did before him.

To hold, as the Tax Court did, that the realization of the point-of-purchase value of a quick asset in cash is gainful because of an appraiser's belated opinion[8] that the fixed assets were worth more than their cost (the lump-sum price paid for the business less the point-of-purchase cash value of quick assets) is to tax assumed gain upon the acquisition of the fixed assets, contrary to this Court's above cited decisions. See also *La Belle Iron Works v. United States,* 256 U.S. 377 (1921).

Since the beginnings of the income tax law it has been accepted that the purchaser of a farming or other business may allocate the lump-sum price first to quick assets, that is, may consider that no taxable gain is realized by converting quick assets to cash at their

---

[7]There is no correlation between the tax consequences of the purchaser's disposition of assets from the purchased bundle and the tax consequences of the seller's disposition of the farm or business for a lump sum price. The latter have received careful attention from the courts and Congress. See *e.g. Commissioner v. South Lake Farms, Inc.,* 324 F. 2d 837 (C.A. 9, 1964); I.R.C. Secs. 1231(b)(4), 268, 337, 341, 1245, 1250.

[8]The appraisal of Hoffman, respondent's witness, which the Tax Court relied upon, was made in 1964, nearly 11 years after the purchase. R. v. ii, 242, 245. It was based upon an analysis of substantially smaller parcels and expressly failed to take account of this transaction. R. v. ii, 246-286, 292-294. The written report of respondent's appraiser, and that of petitioners' appraiser, were returned to the Tax Court and are not available for consideration with this petition, but would be if the writ were granted. The latter report states that the price paid in this transaction is the best evidence of the value of the assets acquired and underscores the marked reduction in price that may be involved where a very large parcel of orchard land, such as the one at bar, is sold.

point-of-purchase value. This is the gist of the Commissioner's ruling in O.D. 714, 3 C.B. 49, issued in 1920 and still extant,[9] that where land is purchased with a growing crop upon it, the gain or loss upon the sale of the crop is the difference between its net selling price and the "fair market value thereof at the time of purchase."[10] The ruling does not require pro rata allocation between value of land and crop.

The acceptance of this principle is also evident from the many cases in which first allocation of price to the quick assets has been conceded by the Commissioner[11] and by two cases in which the point was at issue. *Apex Brewing Co., Inc. v. Commissioner*, 40 B.T.A. 1110 (1939), acq. 1940-1 C.B. 1 (holding that a lump-sum price should be allocated first to beer inventory); *Harlan E. McGregor v. Commissioner*, T.C. Memo Dec. 1955-223, 14 T.C.M. 897 (holding that crops bought with land had a basis equal to their sale value).

In addition to the case at bar, there is another current case that questions accepted principles of allocation of a

---

[9]It was cited with approval in I.T. 3815, 1946-2, C.B. 30.

[10]Assuming that no part of the price was specifically assigned to the crop by the purchase contract.

[11]*The American Fork and Hoe Company v. Commissioner*, T.C. Memo of 9-22-43, 2 T.C.M. 842; *Philadelphia Steel & Iron Corporation v. Commissioner*, T.C. Memo 1964-93, 23 T.C.M. 558, aff'd. 334 F. 2d 964 (C.A. 3, 1965); *Estate of James F. Suter v. Commissioner*, 29 T.C. 244 (1957), acq. 1958-2 C.B. 8; *Richard J. Zemmer v. Commissioner*, T.C. Memo 1963-131, 22 T.C.M. 638; *Fox & Hounds, Inc. v. Commissioner*, T.C. Memo 1962-229, 21 T.C.M. 1216; *James K. Herbert v. Commissioner*, 62-1 U.S.T.C. 9177 (Dist. Ct. Cal. 11/14/61); *Henry S. Alper v. Commissioner*, T.C. Memo 1962-38, 21 T.C.M. 185 (issue concerning Middlebelt Livonia); *Farmers Cotton Oil Company v. Commissioner*, 27 B.T.A. 105 (1932), non-acq. on another point XII-1 C.B. 16. In the *Herbert* case $45,000 of the $158,800 paid as price for the ranch represented a first allocation to the growing crop agreed to by taxpayer and Commissioner.

lump sum price paid for a going business; no appraisal was involved, the question being whether a discount from book value should be allocated entirely among fixed assets. *F. & D. Rentals, Inc. v. Commissioner,* 365 F. 2d 34 (C.A. 7, 1966), cert. den. 385 U.S. 1004 (1-9-67), aff'g. 44 T.C. 335. The case holds that quick assets entitled to first price allocation include accounts receivable, factory supplies and prepaid items, but not inventory and work in process which require post-purchase effort for conversion to cash and are therefore not cash equivalents. It is in conflict with the Ninth Circuit's decision here that the lemon crop, a quick asset,[12] was not so entitled even though cashed at the very point of purchase.[13]

In its opinion below, the Tax Court did not refer to the applicable O.D. 714 or *Harlan E. McGregor v. Commissioner, supra,* which were cited to it, but relied primarily upon *T. H. Symington & Son, Inc. v. Commissioner,* 35 B.T.A. 711 (1937), acq. 1937-2 C.B. 27, and *Nathan Blum v. Commissioner,* 5 T.C. 702 (1945). These cases do not support the Tax Court's

---

[12]An orchard crop is property held for sale to customers in the ordinary course of the business both of the seller and of the purchaser of the orchard. *Watson v. Commissioner,* 345 U.S. 544 (1953).

[13]The decision below involves an inconsistency within itself in that it does not disturb the acceptance by both Commissioner and petitioners of the principle of first price allocation to such quick assets as accounts receivable and lemons in the packing-house (App. B 22) even though, because of delay in their conversion to cash, they were not as clearly equivalent to cash as was the lemon crop. This curious result cannot be justified by reference to the fact that the major portion of the crop was not ready for harvest. It was sold in its then condition at a price discounted from what a mature crop would have sold for (App. B 6-7); in other words, the value of the crop as it had developed up to the point of orchard sale was immediately realized in cash by the orchard purchaser; no post-purchase effort was required to realize that value.

allocation method, but do point up a fundamental distinction that must be made in the area of lump-sum price allocation. If the purchased aggregate is homogeneous—if the assets are of essentially the same kind and acquired for the same kind of disposition—pro rata allocation of cost among them is proper in order that gain or loss may be recognized as they are disposed of. In *Blum* one partner bought, at a discount from book value, the other partner's interest in a partnership, the assets of which were virtually all of a current nature; held, the purchase discount had to be prorated among the book values of the acquired assets. In *Symington,* preferred stock was redeemed at a premium out of a bundle of securities and receivables that, through reorganization, had been segregated into a separate corporation for liquidation; held, the new corporate owner was taxable on the redemption premium. Unlike the case at bar, neither of those cases involved profit implied from an appraisal of retained assets.

Similarly, in *L. M. Graves v. Commissioner,* T.C. Memo of 5-14-52, 11 T.C.M. 467, cited by the Tax Court, business assets were purchased for liquidation and were liquidated during two taxable years. The Tax Court required allocation of cost (pro rata according to resale prices realized) in order to achieve year-by-year tax accounting for the liquidation process. This kind of decision is inapposite to the acquisition of fixed assets, to be held and operated, in the same bundle with quick assets, to be promptly converted to cash.

Except for the decision below, it has been recognized by all decisions dealing with lump-sum price allocation[14] that a cash-equivalent asset, like cash, is entitled to first price allocation. Although these decisions exhibit some difference of opinion as to what a "cash equivalent" is, all would seemingly agree that a quick asset is a cash equivalent if converted to cash at the moment of purchase, as was the lemon crop here.

Whether the correct rule is that of O.D. 714, *supra,* and cases following its theory, that no gain is demonstrated by realizing in cash the acquisition value of quick assets, or whether it is that of *F. & D. Rentals, Inc., supra,* that the acquisition value of quick assets can be realized tax free only if this requires no substantial post-acquisition effort, the kingpin decision is that of the Ninth Circuit in the instant case. If it is allowed to stand, it sweeps away all of the other decisions, for it finds a profit in point-of-purchase cash realization from an obvious cash equivalent.

The condition of the tax law in this area, which for many years has been considered stable, is left chaotic by the decision below. If it stands, no farmer can buy land with a crop upon it, and no businessman can buy a going business, without the risk that a tax auditor may later propose taxable gain in the disposition of crop or quick assets based upon opinion tes-

---

[14]Including *F. & D. Rentals, Inc. v. Commissioner* and *L. M. Graves v. Commissioner, supra.* Accord, *The Bessemer Limestone and Cement Company v. Commissioner,* T.C. Memo Dec. 1956-250, 15 T.C.M. 1277, 1283.

timony that the fixed assets were worth more than their cost. Examples of the concern with this decision in the farming community are contained in Appendix C.

Conclusion.

The writ should be granted for the reasons that:

1. The decision below conflicts with decisions of this Court that taxable gain is not realized upon property until it is disposed of and, specifically, is not realized upon the acquisition of property.

2. The decision below conflicts with that of the Seventh Circuit Court of Appeals in *F. & D. Rentals, Inc. v. Commissioner, supra.*

3. The decision below unsettles an important and historically stable area of the tax law, reversing a principle that has been applied over many years by the Commissioner, taxpayers and the courts. It renders uncertain the tax consequences of and may impede purchases of farms and going businesses.

4. In writing no opinion of its own—merely affirming per curiam an opinion of the Tax Court that could hardly be called penetrating—the court below has upset an important area of tax law without adequate or enlightening appellate consideration.

Respectfully submitted,

ARTHUR A. ARMSTRONG,
ARMSTRONG, BROWN & SHERMAN,
Counsel for Petitioners.